

A correction not a bear market

- For most of July financial markets followed the pattern of the last few months. Equities performed positively, credit spreads remained tight, bond yields remained low in Europe and gradually moved up in the US. However, during the last trading days of July, on the back of rising geopolitical tensions and softer European growth data, the mood worsened significantly. The last two trading days left most major developed equity markets in the red. Europe was hit hardest, with the German DAX index losing 4.1% and the EuroStoxx50 losing 3.3%. The S&P500 index lost 1.4%. The MSCI emerging markets index, however, despite losses at the end of July, remained in positive territory and gained 2%.
- The macro data confirmed the widening growth gap between the US and Europe. While the US GDP grew 4.0% QoQ annualized in Q2, Eurozone growth is expected to remain considerably lower in Q2, and Italy even fell back into recession with Q2 GDP falling 0.2% QoQ after a drop of 0.1% in Q1.
- The widening growth gap and diverging monetary policies finally led to a stronger USD and a further widening of the yield gap. The USD strengthened vis-à-vis most major currencies. The EUR-USD exchange rate, for example, fell 2.3% in July and is currently trading around 1.34. US 2Y yields rose by 9 basis points in July while German 2Y yields remained unchanged at 0.03%.
- Geopolitical risks took center stage at the end of July and drove market sentiment. Worryingly, the problem focused not only on one situation but on a number of trouble spots: heightened tensions in Ukraine, the Israeli intervention in the Gaza strip, the situation in Iraq, which in early August led the US to announce military interventions against ISIS. Other developments weighing on the investors' mood have been the situation regarding a potential further default by Argentina, the insolvency and restructuring of the second-largest Portuguese bank, Banco Espírito Santo, and the Ebola virus outbreak in Africa.
- We regard the latest market move as a correction and stay constructive for risky assets, i.e. equity and credit markets. We continue to favor emerging markets over developed markets and expect further USD strength. The major risks remain geopolitics, a growth slowdown, especially in Europe and / or China, as well as an earlier than expected Fed rate hike.



Macroeconomics and financial markets

Leading US indicators suggest that the US economy is well on the recovery path. GDP grew 4.0% QoQ annualized in Q2. This is without doubt a strong reading, but it has to be put into perspective on the back of the very weak first quarter, when US GDP fell 2.1% QoQ annualized, due to bad weather conditions and some statistical peculiarities. In addition, the US ISM index rose to 57.1 from 55.3 in June, and labor market data remained very robust. At the same time, European data were mixed. Italy slid back into recession with Q2 GDP falling 0.2% QoQ after a drop of 0.1% in Q1. The central bank statements did not add significant news or new guidance. However, we were surprised at how explicitly ECB's president Draghi tried to talk the Euro down at his press conference on August 7. He offered a long list of reasons why the Euro has fallen and seemed to be pleased at the prospect of a weaker Euro boosting the fragile European economic recovery.

Until the last few days of July, markets performed in line with recent months: major equity indices performed positively and US yields were gradually moving up. On July 29, however, we saw equity and credit markets starting to sell off on the back of rising geopolitical tensions. In early August we observed a typical risk-off environment with risky assets selling off and government bonds rallying. We think this has been due to the geopolitical tensions and to a lesser extent to European growth concerns.

Equity markets started to sell off at the end of July

July started with positive equity markets. However, during the last few trading days of July, markets started to correct. Developed markets lost 1.67% in the month, while emerging and frontier markets were able to maintain positive monthly performance figures with 1.4% and 1.3%, respectively. Our view that emerging markets provide better value than developed markets paid off in July.

The sell-off was accompanied by steeply rising implied volatility levels. The VIX index, which fell to a very low level of about 10 in early July, rose steeply at the end of the month to a level as high as 17 (compare Fig. 6). While a level of 17 is still well below the historic mean of 25, the cost of insuring equity exposures has risen very significantly.

In our view, fundamental factors, like economic growth, earnings, valuations still support equity markets in general, being helped also by still very accommodative central banks. We regard the recent sell-off as a typical risk-off movement in the market, predominantly driven by geopolitical concerns, and we remain constructive on the further outlook for equities.



Weak US bond markets – strong European bond markets

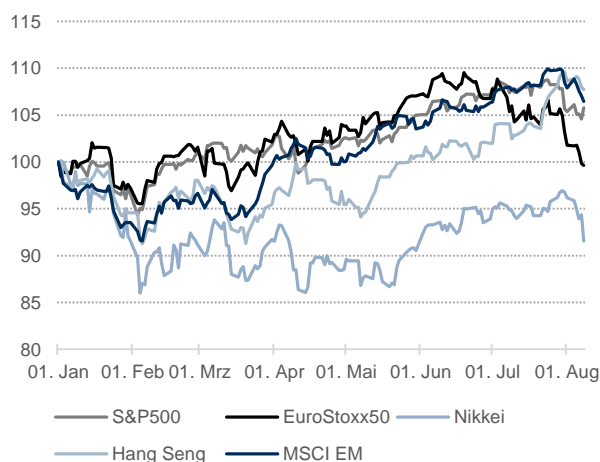
The divergence of the two bond markets continued in July and was particularly pronounced at the short end of the curve (see Fig. 3). While US 2Y yields rose 7 basis points to 0.53%, German 2Y yields remained unchanged at 0.03%. The US 10Y yields rose 3 basis points while German 10Y yields fell 9 basis points.

During most of July credit spreads remained stable until the above-mentioned sell-off led to a considerable widening of spreads in the last few trading days. We also saw emerging market credit spreads, as measured by the EMBI index, widening by about 15 basis points to reach 290 basis points.

Two credit events

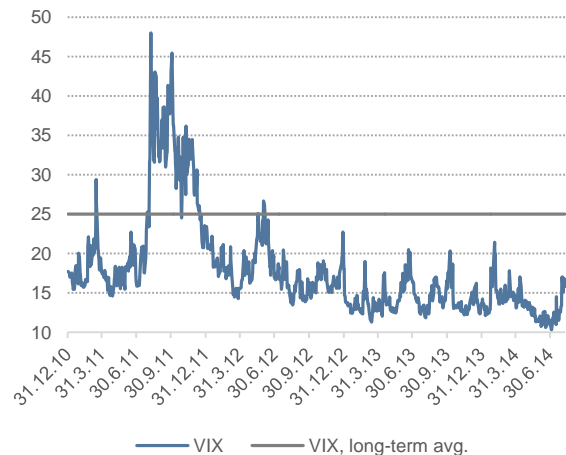
In July we observed two significant credit events, which luckily did not prove to be contagious. First, there was confusion around the ability of Argentina to serve its so-called exchange bonds after holders of defaulted bonds were able to obtain a ruling requiring Argentina to serve those bonds also. Second, the Portuguese central bank stepped in to rescue Portugal's second largest bank, Banco Espirito Santo. The restructuring involved the creation of a good and a bad bank. In effect shareholders and junior bondholders were transferred to the bad bank and will have to take large losses, while depositors and senior creditors received protection via the new Novo Banco.

Fig. 1: Major equity markets, 2014



Source: Datastream, Blue Horizon Wealth Partner AG

Fig 2: VIX Index



Source: Datastream, Blue Horizon Wealth Partner AG



USD strengthens across the board

We have been bullish on the USD for some time based on the widening growth gap between the US and other major economies and diverging central bank policies. It took a while, however, before the USD started to strengthen. We see the current risk aversion as another supporting factor for the USD. In fact, the USD strengthened against most major currencies in July. The EUR-USD exchange rate fell considerably below 1.35 and is currently around 1.34 (see Fig. 4). Furthermore, the GBP-USD exchange rate fell from 1.71 on June 30 to 1.68 currently.

Geopolitics

The conflict centering on Ukraine escalated with heavy fighting in the eastern part of the country, involving air strikes by Ukrainian forces on cities controlled by separatists, large-scale military maneuvers by Russia close to the border, and mutual sanctions imposed by the West and Russia. At the same time, we saw heavy fighting in the Gaza strip and very tough action taken by the Israeli military.

On top of all the afore-mentioned bad news, on August 7 President Obama authorized airstrikes in Iraq to assist Iraqi government and Kurdish forces in their fight against the Islamic terror organization ISIL (Islamic State of Iraq and the Levant) also known as ISIS (Islamic State of Iraq and Syria). For more details we refer to our last month's Wealth Management Review. The situation in Iraq has worsened considerably and the US air strikes have begun.

Apart from geopolitical and humanitarian considerations, the potential impact on markets is also an important question. While the oil price may always be pushed higher by tensions in the Middle East, in recent weeks oil prices have even fallen. For now, we see little indication that the Gaza or the Iraq conflict will have major implications for financial markets. In our view, however, the Ukrainian crisis has a much higher potential to impact the economies of Russia and Western Europe, with potentially major implications for financial markets. The Russian restrictions on food imports from the West have already had a marked effect on foodstuffs shares and are likely to drive up food prices in Russia. It cannot be excluded that the delivery of Russian gas to Europe could be affected, with potentially major gas price rises. Since trade between the US and Russia is much less intense than that between Europe and Russia, the US economy is less exposed. Potential winners as a result of the sanctions are likely to be some emerging markets, which may be able to step in and fill potential shortages of food and energy.



Outlook

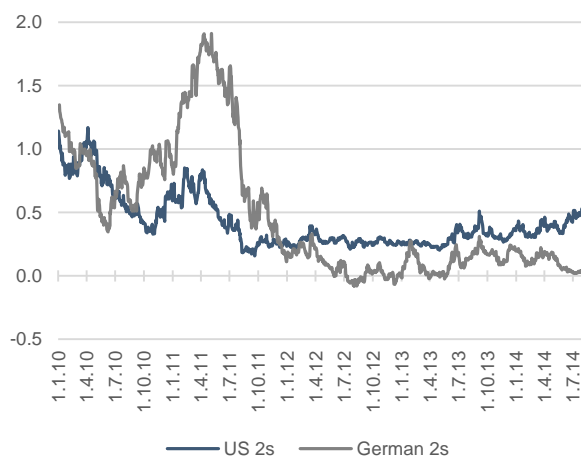
We see the current equity sell-off as a correction and not as the start of a bear market. We remain cautious on US treasuries and bullish on the USD.

The sell-off, which started at the end of July and has extended well into August has been triggered by geopolitical concerns coupled with disappointing European growth data. Meanwhile the US recovery looks very robust and the Fed is likely to raise rates for the first time in Q3 2015. This also means that the Fed is reducing monetary stimulus only gradually and very cautiously. At the same time, the ECB made clear that it is committed to fight deflation and further economic weaknesses in Europe. Also, the Bank of Japan is firmly committed to generate inflation of 2%, which will require further prolonged quantitative easing.

We conclude that equity and credit markets remain well supported by fundamental factors together with global monetary policy support. We continue to prefer emerging markets equity over developed markets, based on more attractive valuations. We would buy equity into the current weakness and sell gold on current strength. US 10Y yields are likely to rise towards 3% and the USD to stay on the strong side with EUR-USD falling below 1.30 in the next couple of months.

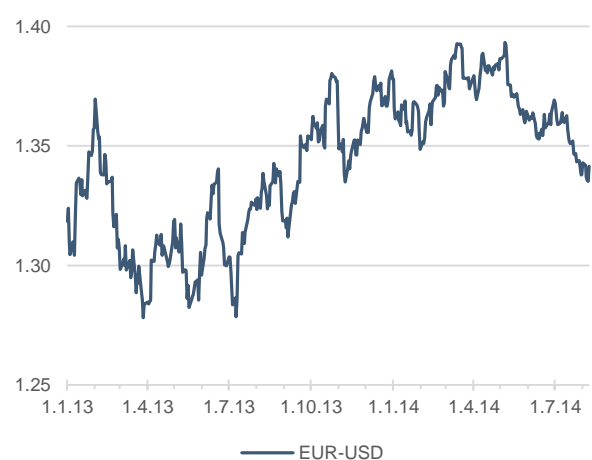
Major risks to our assessment remain the afore-mentioned geopolitical factors, earlier than expected Fed rate hikes and weaker growth in Europe and / or China.

Fig. 3: US and German 2-year yields



Source: Datastream, Blue Horizon Wealth Partner AG

Fig 4: EUR-USD exchange rate



Source: Datastream, Blue Horizon Wealth Partner AG



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